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FIRST ANALYSIS

News or events that may affect your investments **July 31, 2023**

Paul Christopher, CFA
Head of Global Investment Strategy

Q&A: Managing through the equity rally of 2023

Key takeaways

- This year's impressive equity rally has been driven by strong sentiment, without either the earnings growth or the directional improvement in economic data to justify current market multiples and valuations.
- Our outlook for slower disinflation, a slowing economy, and narrowing profit margins leads us to believe that equity markets are overextended at current levels and leaves us cautiously positioned.

What it may mean for investors

- While we remain favorable on U.S. Large Cap Equities, as we have been throughout the rally, we favor a proactive and diligent approach that includes rebalancing portfolios and looking for other long-term opportunities in today's markets.

The 2023 year-to-date rally in the S&P 500 Index has been impressive. The index rose 18% from March 13 to July 27 and is up 27% since the October 12, 2022 low.

While the stars may have aligned briefly behind disinflation, resilient consumer spending, and job growth, we remain cautious. The economy is still slowing, and profit margins are narrowing. Meanwhile, we believe inflation's decline will pause and may temporarily reverse, keeping interest rates higher than the market consensus reflects.

Our 2024 year-end S&P 500 Index target range (4600-4800) suggests eventual upside from these levels, but we expect a bumpy and range-bound ride before the bull truly gets loose. For now, we see continued range-bound trading and favor a patient and disciplined approach that emphasizes quality. The questions below reflect those we are hearing most often from investors.

1. Can inflation continue to fall as quickly as it did in May and June?

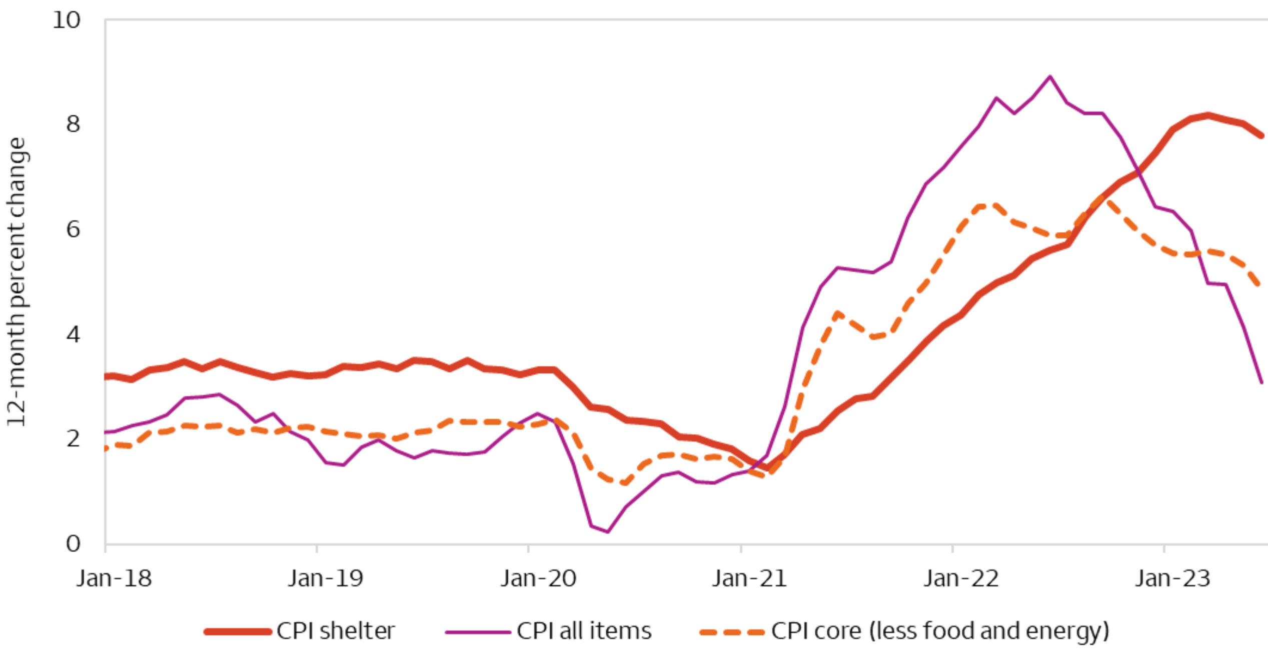
We think inflation will level out or even bounce higher in the coming months. The 12-month Consumer Price Index (CPI) inflation rate has come down from its June 2022 high of 9.1%, but the pace has been uneven across categories in the household budget. Inflation in goods prices has fallen far faster and is likely to continue to approach the Federal Reserve's (Fed's) 2% target by year-end. Inflation in services has been stickier. The June reading on services inflation was 6.2%, still more than triple the Fed's target.

Wages are the first of two sticking points. Wage inflation has eased, as more people have joined the labor market, but several factors may temper or reverse the progress. Household spending on services is still strong, and a recent survey of small business owners indicated plans to continue hiring, paying higher wages, and charging higher prices over the coming six months. Another looming complication is the confluence of seven actual or possible labor strikes that could trigger a new round of higher wages.

The larger source of inflation has come from shelter costs. New home building has been strong, but existing home sales are a much larger part of the housing market and have been in scarce supply. Only 14 of every 1000 homes changed hands in the first half of 2023, below the 19 per 1000 in the first half of 2019.[1] Homeowners may be unwilling to sell, if doing so requires a new purchase with a 7% mortgage. In turn, scarce home supply keeps selling prices elevated, leaves potential buyers stuck in rentals, and keeps rents — and associated shelter cost inflation — elevated.

The media have highlighted that headline CPI inflation continues to fall quickly (Chart 1), reflecting the end of supply chain disruptions. But the core measure of inflation, which excludes volatile food and energy prices, has been higher and stickier. Elevated shelter inflation is likely to keep core inflation sticky, in our view, and wages pose an upside inflation risk.

Chart 1. U.S. inflation is still sticky



Sources: Federal Reserve Bank of St. Louis and Wells Fargo Investment Institute. Monthly data: January 2018 – June 2023.

Beyond wage and shelter cost inflation, other factors are likely to limit inflation's decline. In the coming months, it will become tougher for the 12-month numbers to show declining inflation. The comparison point from 12 months earlier will reach back into the second half of 2022, when inflation was already declining. What's more, some elements of inflation that were falling 12 months ago have already rebounded. For example, gasoline futures prices are quietly up over 26% between May 3, 2023, and July 21, 2023.

1. "U.S. home turnover rate in H1 falls to lowest in a decade, Redfin says", July 18, 2023, Seeking Alpha.

2. Can the Fed plan to cut interest rates soon?

We expect interest rates to stay higher for longer. Rate markets currently are pricing in no further rate hikes and anticipate rate cuts by March 2024. We are skeptical that the Fed can step aside quite so soon. It's worth remembering that 1970s inflation leveled out but then reaccelerated. This Fed has taken pains to emphasize that it will stay resolute in fighting inflation.[2]

Meanwhile, both market-based measures and consumer surveys of expected future inflation remain above the Fed's 2% target. Our work suggests that core inflation (dashed line in Chart 1) may not even dip below 3% until early 2024. If inflation's downtrend flattens or backs higher, a more aggressive Fed could prolong uncertainty and trigger equity and fixed income market volatility. The evidence suggests it's too soon to call "mission accomplished" on lowering inflation.

3. What about a recession in the economy and corporate earnings?

An eventual economic recession still seems likely to us, but a corporate earnings recession is already here. We expect earnings to contract further as the economy slows. For perspective, the 2008 and 2020 recessions arrived in the wake of shocks that shook the entire economy, but during the 1970s, the economy's sectors cascaded into contraction, generally in order of their interest sensitivity: housing, then manufacturing and credit, and finally consumer spending and the labor market.

That sequence is already well along. U.S. total home sales have been declining steadily since December 2021, some segments of manufacturing have contracted, corporate bankruptcies have risen since March 2022, and S&P 500 Index consensus 12-month-ahead earnings estimates peaked in June 2022. As interest rates have risen, credit has become more expensive and difficult to obtain. Commercial and industrial loans have declined since March 2023.

Household spending typically has been among the final economic pillars to contract. Spending and the labor market have been resilient, but cracks have been increasingly apparent. The June U.S. retail sales report showed that households reduced spending on necessities. This typically occurs as households rearrange increasingly stressed budgets to maintain discretionary spending. The October restart to student loan repayments should add to the stress, in our view.

Also, new data from the Federal Reserve Bank of New York on credit access between February and June show that households increased applications for credit cards, home equity loans, and mortgage refinancings. But loan officers responded by increasing rejections, and, in particular, rejected auto loans at the highest percentage of applications since 2013.[3] And data from the Federal Reserve Bank of St. Louis through first-quarter 2023 reported record credit card delinquencies at small- and medium-sized banks. While in aggregate the consumer is still strong, the data tell us that many households are feeling budget and credit access pressures that translate into lower consumption.

Likewise, strength in the labor market is clear, based on the top-line data on job creation, but the job market is normalizing. The share of people aged 25-54 now in the labor force is near an all-time record. As people return to the labor force, average weekly hours are declining to pre-pandemic levels, while manufacturing overtime hours have dropped 18% in the past 16 months. As household spending continues to weaken, we expect to see more businesses cancel open positions and feel more comfortable letting workers go.

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2. For example, see "Top Fed official warns of risk of 1970s-style inflation", *Fortune,* February 22, 2023.

3. Survey of Consumer Expectations "Credit Access Survey", Federal Reserve Bank of New York Center for Microeconomic Data, July 20, 2023.

No two recessions arrive with the same timing. In this case, households and businesses still have cash cushions. Still, the bottom line is that parts of the economy already are in recession, and the trends in spending and employment are weaker. Ultimately, we believe the economy will struggle to avoid a recession.

Corporate earnings fell in each of the past two quarters, and halfway through second-quarter earnings season, the earnings recession remains on track. The Bloomberg consensus of analysts has cut its estimates by more than $30/share during the past year, and we expect further cuts while the economy trends weaker. We expect a pullback in equity prices as the consensus corrects its expectations.

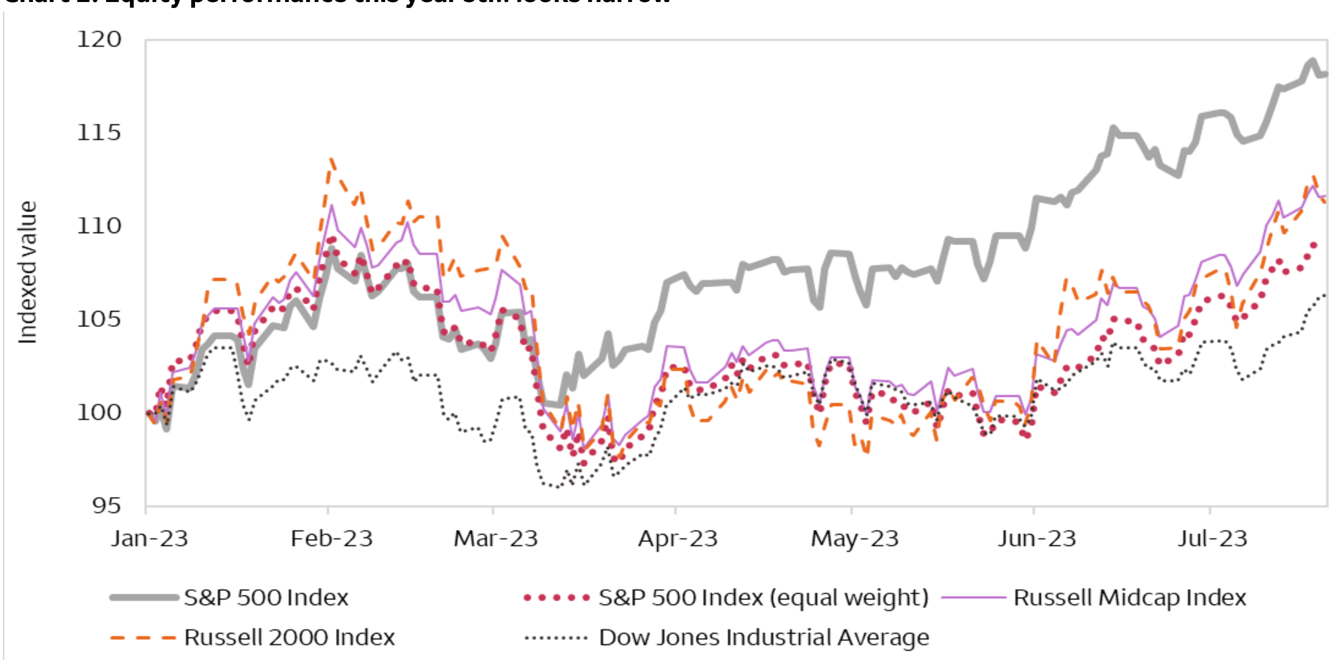
4. Is this equity rally broad-based?

Yes, the S&P 500 Index is up nicely on the year, but equity markets generally have not reflected the negative economic and earnings outlook. Mid-cap, small-cap, and other large-cap indexes, like the Dow Jones Industrial — and even the equal-weighted S&P 500 Index — have not matched the gains in the S&P 500 Index and remain below their all-time highs from 2022 (see Chart 2). Most indexes are still within their 2023 ranges.

Earnings have been no better for smaller companies than for the S&P 500 Index. This suggests the rallies that Chart 2 shows in the non-S&P 500 indexes have been driven by some investors chasing stocks that look cheap but are not necessarily good values.

The risk that we see to portfolios is that this type of rally is likely to disappoint investors in several ways. First, we believe that the artificial-intelligence (AI) driver for the rally is running ahead of the reality. There are still significant uncertainties to be resolved, especially in how AI integrates into the economy and what regulatory challenges may arise. Second, the fact that the S&P 500 Index has far outgained its equal-weighted equivalent (see Chart 2) signals that the rally is not broad-based and, therefore, not yet consistent with an economy in full recovery. In a third and related concern, an economy about to recover typically has small-cap leadership, but that segment is underperforming the S&P 500.

Chart 2. Equity performance this year still looks narrow



Sources: Bloomberg and Wells Fargo Investment Institute. Daily data: January 1, 2023 – July 21, 2023. All indexes are indexed to 100 as of January 1, 2023. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Consequently, we have favored U.S. Large Cap Equities (over U.S. Mid Caps and Small Caps) throughout this rally. Moreover, within the S&P 500 Index, we favor more quality-oriented sectors. Regarding technology-oriented sectors (Information Technology and Communication Services), we believe a full market-weight allocation (but not an overweight) is the appropriate way to take exposure to the AI theme at this point in time.

5. What do we favor doing now?

Trying to time the market is always more challenging than it appears, as success requires knowing when to get out and when to get back in. Each decision is difficult, because of the temptation to chase market rallies based on emotions and recent performance. Instead, we prefer to regularly rebalance back to our preferred allocations, especially amid a rally that has been driven by strong sentiment, without either the earnings growth or the directional improvement in economic data to justify current market multiples and valuations.

We favor allocating to follow the investor's risk tolerance and long-term objectives, putting new funds to work in a systematic way — by dollar-cost-averaging over time and focusing selections on risk and reward. This typically requires evaluating the long-term opportunities among equities, fixed income, commodities, and selective reallocation from sectors that are overextended to those that offer value. Specifically:

1. **Rebalance among asset classes:** For portfolios with long-term objectives, our guidance all year has been to use pricing extremes to help guide the investor's regular portfolio rebalancing. Most fundamentally, we have reallocated from equities (Emerging Markets, and U.S. Small and Mid Cap) into investment-grade fixed income, primarily U.S. Short Term and U.S. Long Term Taxable securities, pending a bottoming in the economic downtrend. In equity sectors, we favor taking profits in the technology-oriented sectors and reallocating to our more defensive, quality-oriented preferred sectors. We also see an opportunity to rebalance internationally, by bringing the Developed Market ex-U.S. Equities allocation to its long-term strategic or target allocation.

   We continue to expect an economic and earnings rebound in 2024, which should produce an opportunity to add exposure more broadly across equity markets. But, for now, patiently rearranging portfolios for the opportunities available remains the watchword.

2. **Consider other potential opportunities also:** Aside from equities, we remain favorable on investment-grade U.S. Long Term Taxable Fixed Income and on Commodities as potential opportunities for long-term investors. While volatility persists in these markets, we favor a disciplined and incremental allocation of excess cash.

3. **Our equity sector favorites are unchanged:** We favor the Energy, Health Care, and Materials sectors, which have underperformed during this rally but should generate cash and have attractive long-term revenue prospects, in our view. We downgraded the Information Technology sector from favorable to neutral in June, and we remain neutral on Communication Services. A full, market-weight position in these technology-oriented sectors should help investors participate in any further AI-related gains, but with less potential risk as the rally becomes more overextended.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues. T**echnology** and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market. **Communication** services companies are vulnerable to their products and services becoming outdated because of technological advancement and the innovation of competitors. Companies in the communication services sector may also be affected by rapid technology changes, pricing competition, large equipment upgrades, substantial capital requirements and government regulation and approval of products and services. In addition, companies within the industry may invest heavily in research and development which is not guaranteed to lead to successful implementation of the proposed product. A periodic investment plan such as **dollar cost averaging** does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider his or her ability to continue purchases through periods of low price levels.

Definitions

Dow Jones Industrial Average is an unweighted index of 30 "blue-chip" industrial U.S. stocks.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index. Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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